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UNCLAS SECTION 01 OF 02 VIENNA 001606

SIPDIS

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SUBJECT: AUSTRIAN AIRLINES? PRIVATIZATION IN TROUBLE

REF: (A) VIENNA 1372; (B) VIENNA 1130 and previous

¶1. Summary: The GoA's plans for selling AUA by the end of October failed because of the miserable handling of the privatization process, which was aggravated by the financial crisis and the stock market problems, which alone should have triggered calling off or postponing the sale. On October 29, the GoA extended the privatization deadline to year's end 2008. Since the major problem for the bidders is AUA's debt burden of about Euro 1 billion, the GoA also decided on a maximum Euro 500 million state subsidy for AUA by way of a debt relief or equity injection. The GoA still has to coordinate this state subsidy with the EU Commission for compatibility with EU competition regulations. AUA's latest financial report will only make potential buyers even more cautious. End Summary.

Messed-Up Procedure

¶2. As in earlier privatization cases, the GoA and its holding company (and majority owner of AUA), the OIAG, showed unprofessional handling of the AUA case ? aside from the financial crisis and the stock market problems, which alone should have triggered calling off or at least postponing the sale, according to many experts. Lufthansa reportedly was the only bidder to submit a binding offer, but this reportedly included a request for a debt relief and rejection of any guarantee for AUA's continued existence. The Russian airline S-7 reportedly submitted a non-binding offer, stipulating conditions under which it would consider an investment. Air France/KLM refrained from submitting an offer.

¶3. It is no surprise, however, that AUA's privatization ended up in such difficulties, not only because the GoA first delayed its privatization decision and then tried to sell the airline in a rush. The information policy of all involved parties, GoA, OIAG, and AUA, was miserable and left the public and potential bidders confused. The openly shown bias of many for Lufthansa was certainly not helpful, either. Moreover, GoA/OIAG expectations for a high sales price under the conditions stipulated (i.e., taking over AUA's debts, maintaining the AUA brand name, guaranteeing AUA employees' jobs, accepting that Austrian shareholders hold a blocking minority of 25%

plus one share, and maintaining Vienna International Airport (VIE) as CEE/SEE hub), were probably deal-breakers from the beginning.

#### Government Extends Deadline for AUA's Privatization

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¶4. When it became clear that the privatization procedure would not be completed by the end of October, particularly given Lufthansa's request for considerable debt relief, the GoA on October 29 extended the privatization deadline by two months to year's end 2008. The GoA also agreed on a maximum Euro 500 million state subsidy for AUA, whether in form of a debt relief or equity injection remains unclear. The most pressing problem now for the GoA is to make this state subsidy compatible with EU competition regulations, so that it will not qualify as forbidden state aid. The EU Commission reportedly has sent a letter to the GoA requesting notification of any measures and offering help in structuring them according to EU regulations.

¶5. The fresh GoA capital for AUA presents a new situation and indications are that Air France/KLM, and possibly S7, will reconsider submitting an offer.

#### AUA's Needs in Case Privatization Fails

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¶6. If the GoA's Euro 500 million injection is

VIENNA 00001606 002 OF 002

approved, AUA should not face a liquidity squeeze in the near future. However, if privatization fails completely, the airline will likely need additional fresh money in the coming year to survive. Also, expectations are that AUA would have to shrink considerably to a regional airline and implement harsh cost-cutting. AUA would likely have to cut more long-haul destinations (limited cuts were announced Oct. 28), ground its six Boeing 767 jets used for these destinations, and cut up to 2,000 of the current 8,000 jobs.

#### AUA's Performance in 2008

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¶7. AUA recently published miserable third quarter results and a higher-than-projected loss for 2008. News also leaked that AUA's debt, so far estimated at some Euro 900 million, has meanwhile exceeded Euro 1 billion. AUA's third quarter 2008 results show a net loss of Euro 16.4 million and of Euro 65.1 million for the first three quarters. Since AUA reports that the economic downturn has already led to a decline in flight bookings and expects that a further drop in demand in the fourth quarter as well as negative effects from fuel hedging and an increasing US\$ exchange rate, the projected net loss in 2008 will likely reach Euro 100-125 million rather than the so far projected Euro 70-90 million.

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